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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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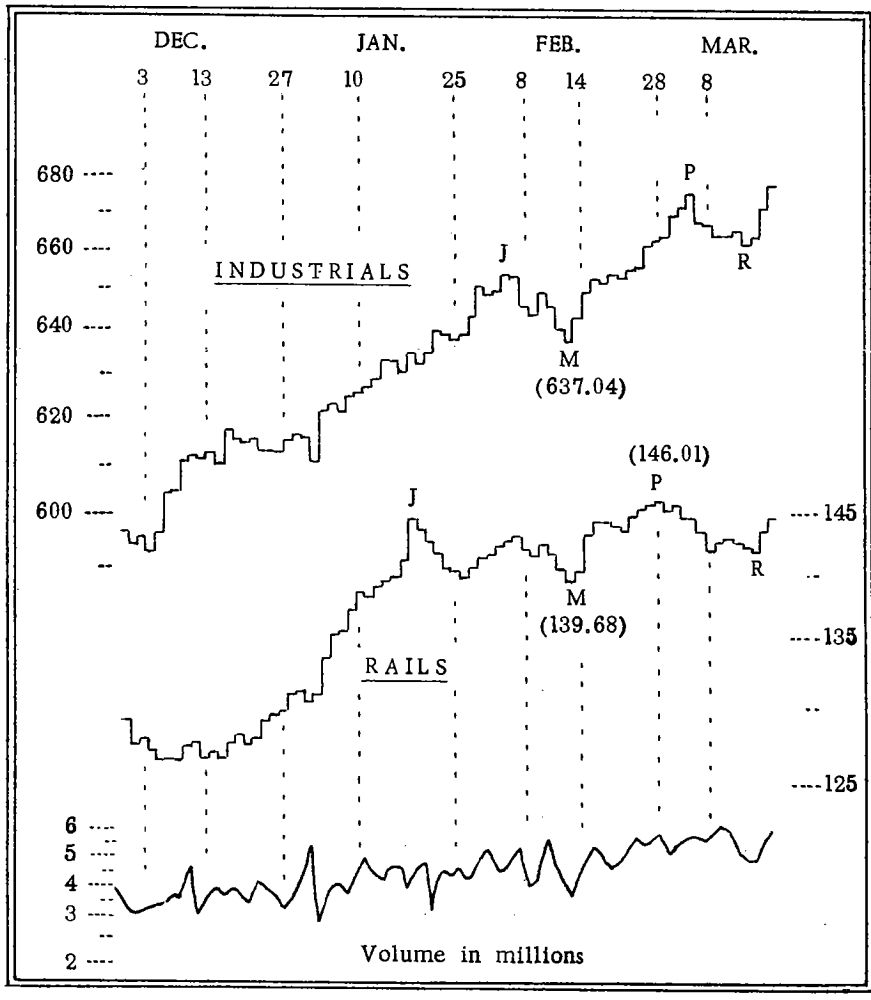
PRICE MOVEMENTS Following the recent peaks at P, the two Averages backed down with almost studied care. Industrials formed a single minor descending zig-zag; Rails formed two minor descending zig-zags but held well above their lows at M (139.68). At the minor decline points (R) volume contracted to 4.9 million shares on two successive days (the lowest volume since February 20). On March 16 both Averages surged higher as volume expanded sharply. March 17 saw Industrials rise to a new recovery high above P, while Rails halted approximately 2 points below the 146.56 high.

As long as one or both Averages hold above the M points (Industrials 637.04, Rails 139.68) the secondary trend will remain bullish. Danger signals would be (1) diminishing volume as the rally progresses, (2) a continued refusal by Rails to better the secondary peak of 146.56.

The Rail performance over the last year has been a remarkable one. Since March, 1960, Rails have tried four times (June and August, 1960, January and February, 1961) to better the 146.56 high. If enough "wise money" is sure of a forthcoming pickup in freight car-loadings, the "floating supply" of rail stocks will be cleaned out, and the Rail Average will better 146.56 (thus providing a bull signal). But if there are more rail certificates around than wise money, then the 144-46 area will become saturated with rail stocks and the rails (together with the general market) will turn down again.



THE MARKET I have explained in many previous Letters that under Dow Theory the primary trend is taken to remain in force until reversed by an authoritative counter-signal. The last confirmed direction of the primary trend was down (the bear signal was given March 3, 1960, and that signal has not since been revoked).

From their January, 1960 peak of 685, Industrials declined 119 points to a low of 566 established in October, 1960. That decline extended over a ten month period. In four months the Industrials recovered 90% of their 1960 losses. Since primary movements tend to be long and plodding, and movements against the primary trend tend to be violent and rapid, the time element of the recovery was bearish.

The Industrials gave one half of a bull signal by bettering their June, 1960 high (656.42). Rails have (so far) refused to confirm the Industrial penetration by bettering their corresponding 146.56 secondary peak established in March, 1960. Until or unless Rails do confirm, the price structure must be

taken bearishly.

Volume tends to expand in the direction of the primary trend of prices. While many bear market (upward) reactions have ended on heavy volume, the tendency of volume on the rise since October, 1960, has been to expand as prices worked higher. This has bullish implications. It should be noted, however, that volume has been heaviest since early February, a period in which Rails have made little or no progress. This fact, in the light of the sluggishness of Rails, could suggest "churning" or distribution.

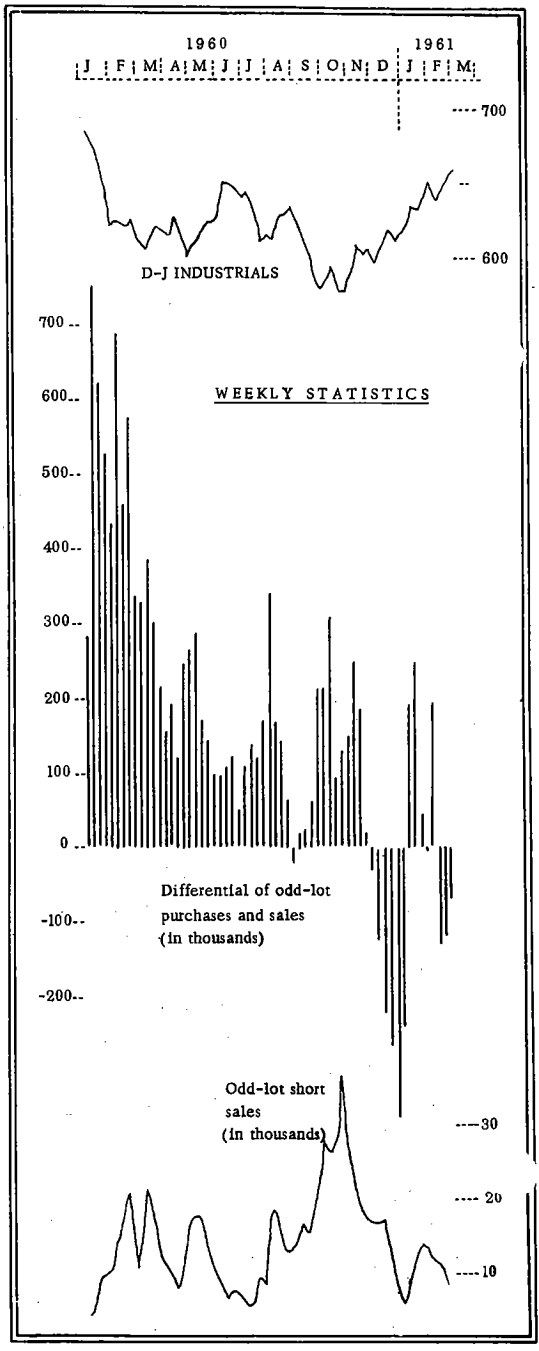
Breadth (advance-decline ratio) has risen rapidly over the last four months, and this must be taken constructively.

Odd-lot transactions (see study in this Letter) have been predominantly on the selling side since the end of November, 1960. The fact that the market rose in the face of poor business news and public skepticism must be taken bullishly.

The short interest ratio has dropped for four consecutive months (I am assuming that it has dropped during the February 15-March 15 period), and this must be taken as bearish.

Tne D-J Industrial Average has held above its long-term or 30-week moving average since the first of the year. The moving average is now beginning to climb. Both of these factors must be taken bullishly.

Stocks (as measured by average yields on the Industrial Average) are in an area of great over-valuation. The trend of earnings on the Industrial Average has been declining since 1956. These two factors constitute an element of danger but cannot pinpoint the end of a move.



ODD-LOTS "The public is always wrong," runs the old Wall Street adage. The odd-lot or under-100-share trader is generally considered to be representative of the public. For this reason most market men are particularly interested in keeping up with what the odd-lot public is doing. Each week the official S. E. C. figures on odd-lot transactions are released (they are published in Barron's). Unfortunately, the official figures are subject to a two-week time lag (the official figures are not to be confused with the daily odd-lot figures which are released on the day after trading by the leading odd-lot specialty houses). For purposes of broad comparison, I find it useful to keep a chart of the total weekly differential between odd-lot purchases and sales together with the total weekly odd-lot short sales figures. The following example will explain the make-up of the chart: during the week ending February 17, 1961, a total of 2,356 thousand odd-lot shares were purchased, and a total of 2,469 thousand odd-lot shares were sold. This means that 113 thousand more odd-lot shares were sold than purchased and a -113 is entered on the chart for that week.

The chart covers odd-lot transactions from January, 1960 to the week ending February 24, 1961. Note the heavy preponderance of odd-lot or public buying during the first quarter of 1960, and more particularly during the month of January, when the market was breaking badly. This suggests that the public started out 1960 in a highly bullish modd, a mood which was to sour a bit in March and April as the market continued down. In May odd-lot buying increased, and the subsequent market rally (to June) proved the odd-lotters to be temporarily correct. Near the June, 1960 peak (656) odd-lot buying diminished, and again the odd-lotters proved to be right. During the July weakness, a sudden spurt of odd-lot buying suggested that the public believed that the lows had been seen. The market advanced into August, and at the August peak (641) public sentiment again grew cautious (the public switched to the sell side for one week at the August top). Then as the market turned down in what was to be a broad break to the October lows, odd-lot buying increased (here public sentiment was dead wrong).

During a good deal of the late 1960 period odd-lot sentiment proved to be rather correct on the trend of the market, a most unusual situation. Nevertheless, it is to be noted that odd-lot purchases never again reached the heights of enthusiasm seen during the first few months of 1960. Certainly on a long-term basis the odd-lot figures during 1960 showed a marked decrease in the odd-lotters' willingness to buy.

Although odd-lotters bought fairly substantially (and correctly) near the September-

October lows, they underwent a complete switch in sentiment as the market finally turned up. For six successive weeks during November and December odd-lots sold more than they bought. The two weeks of buying in early January can be discounted since this is the period when stock dividends are normally reinvested, and this procedure almost always makes for odd-lot buying balances. As seen on the chart, however, buying sentiment has quickly dampened, and during the weeks ending February 10 to 24 selling took over again.

The odd-lot short seller (not to be confused with the regular odd-lot trader) is considered by many market students to be the "wrongest" man in the market. The odd-lot short seller almost invariably needs the spectacle of declining prices before he can muster up sufficient courage to put out his shorts. In other words, regardless of the height or duration of an advance, we do not expect to see odd-lot short selling until the market actually turns down. Note the heavy totals of odd-lot shorts in the vicinity of the October, 1960, lows.

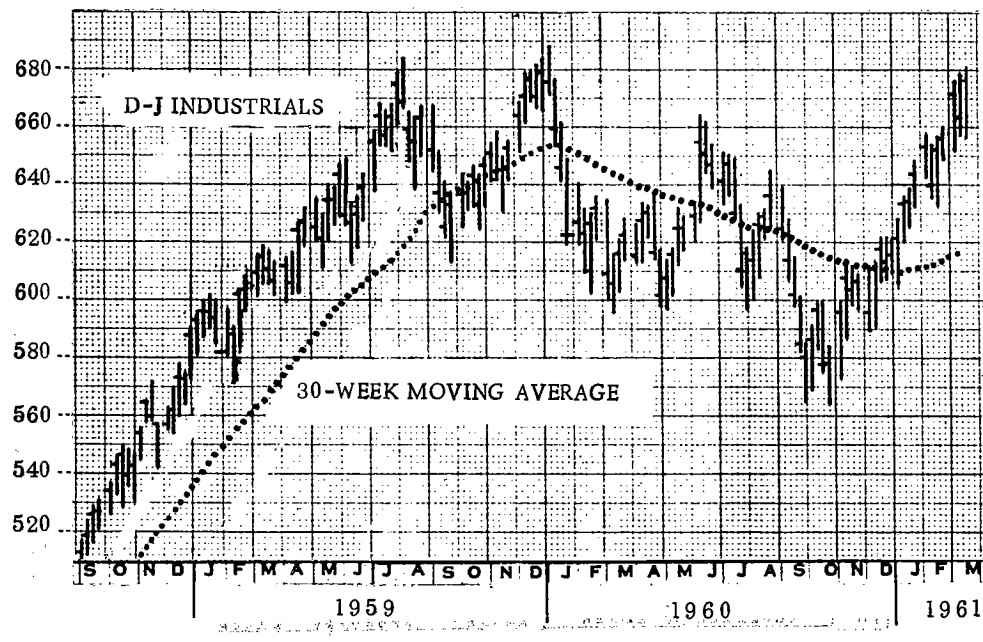
For the reasons already mentioned, the steady decrease in odd-lot shorts since the October, 1960 lows is a normal expectation. History suggests that odd-lot shorting will not again appear in substantial quantities until the next decline is well under way. However, during the next decline if odd-lot shorting holds low it will be a danger signal. The majority of important declines terminate in areas of fairly heavy odd-lot shorting.

MOVING AVERAGE The last Letter discussed Dow's 50% Principle and drew attention to the 620 level in the D-J Industrial Average. It was stated that the halfway point of the entire rise from the October, 1960 low (566) to the recent March high (674) is 620. Any decline which might consolidate or hold above 620 would be taken bullishly under the 50% Principle. Conversely, a violation of 620 would have extremely bearish implications.

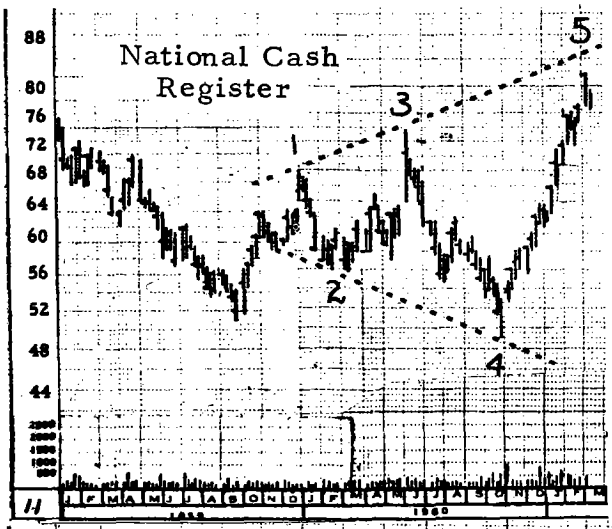
The 620 level takes on added significance because of the current position of the 30-week moving average. The average price of the D-J Industrial Average over the last 30 weeks now stands at 618. The 30-week moving average is simply the sum of the last 30 weekly closings of the D-J Industrials (Wednesday closings are used) divided by 30. As each successive week arrives a new Wednesday closing is added to the total while the 31st Wednesday closing is subtracted. The new sum of the 30 closings is again divided by 30, and this gives the new figure for the 30-week moving average.

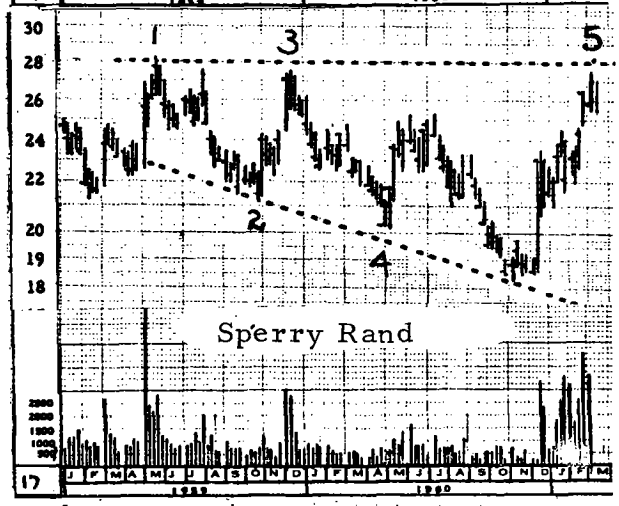
The average price which investors are willing to pay for the high-grade Dow stocks over a 30 week period (or any reasonably long-term period) is significant. In regard to the Industrial Average and its relationship to its own 30-week moving average, the following facts are worth noting: (1) Industrials have now held above the moving average for the longest period of time since 1959; (2) Because of this length of time, the moving average is beginning to climb again (for the first time since 1959 -- see chart).

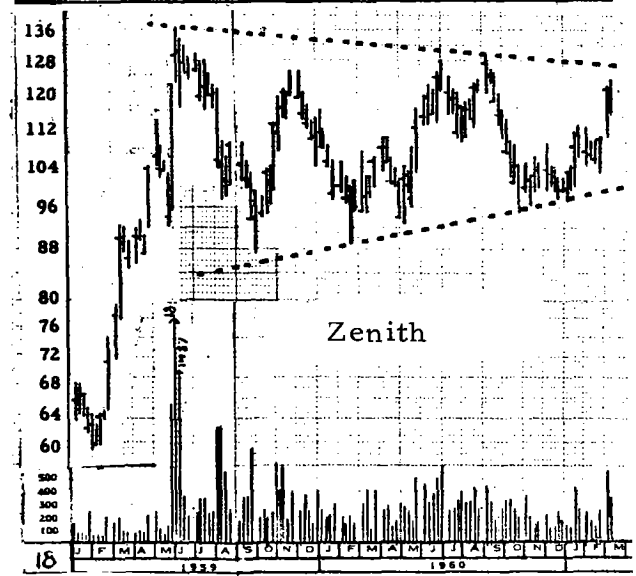
When a stock or an average holds persistently above its own rising moving average, the relationship is generally considered to be a bullish one. In addition, the more often a stock or an average declines and successfully "tests" (but refuses to penetrate) its own moving average the more bullish the relationship. It is to be noted, however, that the advance which carried Industrials above their moving average has continued in a straight line. Thus, there has (so far) been no Industrial test of the moving average since the initial upward penetration in December, 1960.

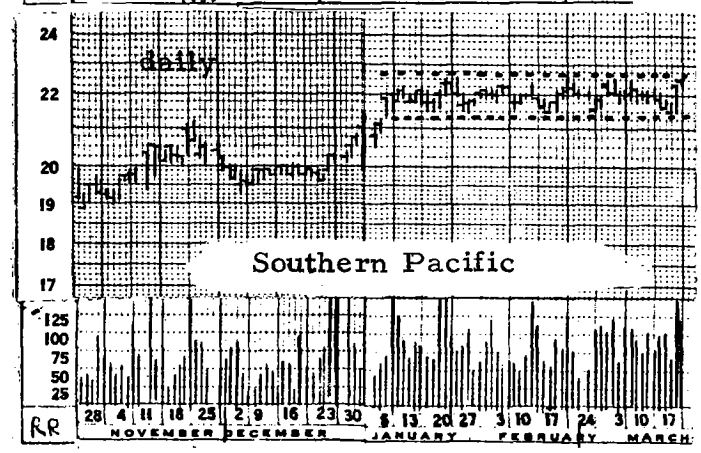


STOCKS One of the most fascinating of chart patterns is the broadening formation. Such formations are essentially five-point reversals, but instead of the reversal swings'









becoming smaller as in normal triangles (see last week's Letter) the reversal swings in broadening formations become progressively larger. Magee and Edwards write about broadening formations as follows: "The broadening formation may be said to suggest a market lacking intelligent sponsorsh' and out of control -- a situation usually in which the 'public' is excite committed and which is being whipped around by wild rumors." Again they note that "nine out of ten times they carry bearish implications." I have shown the weekly chart of National Cash Register; note that each high point (1, 3, 5) is higher than the last, and that each low point (2, 4) is below the last. If the broadening formation is to be complete, Nat. Cash should top out around 85, then turn down and break all lows. It is very common in completed broadening formations for a "pull-back" to occur at point 6, following which the main decline will be resumed. Point 6 (if the formation is to be completed) would come somewhere below 48. Broadening formations are difficult to trade, but shorts should generally be put out around point 5 with "stop-buy" orders around 10% higher.

Sperry Rand exhibits what could well be a right-angle broadening formation. Here the five-point reversal again appears (of course there has not yet been a reversal at 5), but the peaks are on a horizontal plane. Obviously SY has been distributed for two years at the 28-29 level. If the stock refuses this time to break above 30, but turns down instead the odds favor the broadening formation's being completed. Short sales could be put out at 28 with the stipulation that they be covered at 30. Occasionally such a formation does break to the upside and when this happens the force can be considerable.

I have included the daily chart of Southern Pacific RR covering the price action during the last five months. Since January, 1961, SX has formed an amazing "line" with price movements fluctuating within a two-point area (within dotted lines). It is almost certain that SX will move with any broad swing of the Rail Average. SX can be considered a buy on any closing above 23, a short sale on any closing of 21 or below.

Zenith on a weekly chart shows six broad swings since mid-1959. Taken together these swings form a giant symmetrical triangle. The latest advance has taken ZE to the area of the top of the triangle; a closing above 132 would make ZE a buy.

Libbey-Owens -Ford Glass has formed a large rounding bottom (see last Letter). Such formations generally present opportunities for buying. Note the almost geometric symmetry of this formation. (Charts courtesy of Traders Research, Box 6185, Lambert Airport, Missouri)

(Written Monday, March 20th - 2 P.M.)